MOSS-ADAMS LLP
Certified Public Accountants | Business Consultants

WWW.MOSSADAMS.COM
601 West Riverside Avenue, Suite 1800
Spokane, WA 99201
T (509) 747-2600 F (509) 624-5129

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April 10, 2012

Ms. Marlene Dortch
Secretary
Federal Communications Commission
445 12th Street, SW
Washington, DC 20554

Re: Connect America Fund, WC Docket No.10-90; A National Broadband Plan for our Future, GN Docket No. 09-51; Establishing Just and Reasonable Rates for Local Exchange Carriers, WC Docket No. 07-135; High-Cost Universal Service Support, WC Docket No. 05-337; Developing a Unified Intercarrier Compensation Regime, CC Docket No. 01-92; Federal-State Joint Board on Universal Service, CC Docket No. 96-45; Lifeline and Link-Up, WC Docket No. 03-109

Dear Ms. Dortch:

On March 9, 2012, the Wireline Competition Bureau (WCB) of the Federal Communications Commission (FCC) issued a letter outlining the results of a peer review performed on the regression based limitations on capital and operating expenses included in the calculation of High Cost Loop Support proposed by the WCB in Appendix H to the FCC's *USF/ICC Transformation Order and Further Notice of Proposed Rulemaking (FNPRM)*[1]. This peer review was conducted by two departments within the FCC, the Media Bureau and the Office of Strategic Planning and Policy Analysis (Peer Reviewers). While we believe that this peer review was appropriate and necessary, and produced very compelling results,[2] we also believe that further steps are necessary to ensure that the procedures used to create regression based limitations on costs included in the calculation of support are appropriately developed. In addition, it is not typical that a peer review be performed by others within the same organization. While the findings are compelling, it may be beneficial to also seek an external review, including the accounting review recommended in this letter.

[1] *Connect America Fund; A National Broadband Plan for Our Future; Establishing Just and Reasonable Rates for Local Exchange Carriers; High-Cost Universal Service Support; Developing a Unified Intercarrier Compensation Regime; Federal-State Joint Board on Universal Service; Lifeline and Link-Up; Universal Service Reform—Mobility Fund*; WC Docket Nos. 10-90, 07-135, 05-337, 03-109, CC Docket Nos. 01-92, 96-45, GC Docket No. 09-51, WT Docket No. 10-208, Report and Order and Further Notice of Proposed Rulemaking, FCC 11-161 (rel. Nov.18, 2011) (*USF/ICC Transformation Order and FNPRM*).

[2] Moss Adams, on behalf of its clients, is encouraged by the FCC's inclusion of 17 data sets that may be used to modify the regression analysis. However, without knowing how or even *if* the suggested data sets will be incorporated into the FCC's regression model, Moss Adams' ability to provide meaningful input concerning these data sets is severely restricted.

In this letter, we urge the Commission to carefully consider changes to the proposed limitations on capital and operating expenses based on the recent regression analysis peer review comments. Particularly, the peer comments regarding the need to consider alternate underlying variables to predict costs, such as loop length instead of a simple loop count; and the need to resolve omitted variable bias by including items such as bedrock, climate concerns and other characteristics that increase carrier costs. Lastly, both peer reviewers raise significant concerns over the underlying model assumptions such as: disaggregating the total cost function and studying cost lines separately, a one size fits all approach, the choice of costs to limit, the use of a log to log framework, treatment of and a significant number of zero values, etc.

These items alone are material and have a significant impact on the regression analysis and the resulting limitations imposed on rural rate of return carriers. However, in conjunction, we strongly recommend that the Commission conduct a similar peer review on the accounting aspects of the proposed regression analysis, including utilizing the NECA algorithm steps (inputs) as the dependent variables in the regression equation instead of data lines (outputs), not taking items such as accumulated depreciation into consideration, etc.

In order to facilitate the incorporation of the peer review comments, and this additional proposed review, we recommend that the FCC implement the following courses of action:

- Independent of the changes to regression methodology used to compute the limitations; the FCC should not apply limitations to capital expenditures that have already been made throughout the life of the company, but rather develop limitations based on the need for future expenditures.
- The capital and operating expense limitations should be delayed by at least one year to facilitate proper review and resolve the current flaws in the regression analysis.
- During this one year period, carriers should be provided access to the updated regression model and be given the opportunity to assess the results and provide the Commission further comments prior to implementation.
- Once the ultimate computations for the capital and operating expense limitations are determined, they should be performed and be available for a minimum of five years to allow for adequate planning.

Alternate Underlying Variables are Needed to Predict Costs

As indicated in the Peer Reviewers, the FCC's regression model should be modified to incorporate more appropriate density measures as independent variables, such as subscribers per mile of loop plant. The model in its current form is overly reliant on the absolute number of loops and does not take into consideration density concerns which lead to higher cost levels. One of the Peer Reviewers states, "Arguably, the cost of one long loop will be greater than the cost of a short loop, and thus using the number of loops as a covariant distorts the cost predictions on the long loop carrier".

Resolve Omitted Variable Bias

The Peer Reviewers also indicated that several important factors that may explain loop costs have not been included in the analysis. The areas cited are very consistent with those expressed in comments submitted to the FCC in response to the *USF/ICC Transformation Order and FNPRM.* Both the Peer Reviewers and commenters pointed to the need to incorporate more appropriate terrain characteristics as independent variables, such as: presence of bedrock, soil type, length of the construction season, rainfall, etc. Much of this data should be publicly available from the U.S. Geological Survey or other means, as identified in the WCB letter. The Peer Reviewers provided numerous examples where these factors, and others, would impact costs. In addition, one Peer Reviewer stated, "one is puzzled by the fact that in some regressions, the loop costs are higher for housing units in urban areas than rural areas" and that "the housing variable may be proxying for some omitted variables". The regression model, as proposed, omits variables, including the most important variables in determining loop costs. We believe that the proxy approach utilized in Appendix H to the *USF/ICC Transformation Order and FNPRM* is flawed and must be modified.

Resolve Lacking Model Assumptions

The Peer Reviewers raise significant concerns over the underlying model assumptions, such as: disaggregating the total cost function and studying cost lines separately, a one size fits all approach, the choice of what costs to cap, the use of a log to log framework, treatment and significant number of zero values, etc. It is quite clear the Peer Reviewers do not agree with the application of the proposed limitations in their current form, and that numerous aspects of the regression analysis need to be addressed for it to appropriately "identify high cost carriers, set cost limits and spur efficiency". We strongly recommend these areas be resolved and another peer review be conducted to ensure the updated model is appropriate.

Accounting Based Peer Review

The Peer Reviewers noted significant concerns about the regression model, variables and assumptions. A similar peer review process is needed on the application of accounting and financial theory in the analysis. We believe that the proposed regression analysis is not limiting the proper cost components and is applying the limitations incorrectly.

The letter sent to the Peer Reviewers noted two items beyond their charge. First is the fact that the WCB chose calculations from the HCLS algorithm as dependent variables. Second, the WCB defined outliers as exceeding the 90th percentile. What is troubling is the letter goes on to say FNPRM responders suggested something other than the 90th percentile threshold be used, and that is under consideration, however the letter was silent to the use of the HCLS calculation (or algorithm) lines. FNPRM responders also suggested the use of something other than calculations from the HCLS algorithm as dependent variables. We believe that this recommendation should also be under consideration by the WCB.

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The limitations on capital and operating expenses should be applied to company cost data (inputs), not algorithm calculation lines (outputs), in the calculation of HCLS. The latter approach circumvents the HCLS algorithm and yields anomalous results. One significant area of likely accounting error in the proposed calculations is the fact that the limitation on capital and operating expenses did not take the impact of accumulated depreciation and other accounts on the calculation of support into account. Therefore, the analysis does not take net book value into account, only gross investment. It is our strong belief that the Peer Reviewers would have agreed with this position had they not been directed to exclude this from their review. Alternatively, we believe that an accounting based peer review is appropriate to ensure that these items are not overlooked.

We appreciate your consideration of our positions outlined in this letter and would welcome further discussion of our concerns with you.

Sincerely,

Clay R. Sturgis, Partner
Moss Adams, LLP
601 W. Riverside Ave., Suite 1800
Spokane, WA 99201
509-747-2600
Sturgis.Clay@mossadams.com